

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

REPORT ON LIMITED-SCOPE EXAMINATION

As of

DECEMBER 31, 2004

Of the

BALDWIN MUTUAL INSURANCE COMPANY

FOLEY, ALABAMA

PARTICIPATION:

ALABAMA

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August 25, 2006

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Honorable Walter A. Bell
Commissioner of Insurance
State of Alabama
P.O. Box 303350
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Dear Commissioner Bell:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, a limited-scope examination has been made of the affairs and financial condition of the:

Baldwin Mutual Insurance Company
Foley, Alabama

At its home office located at 315 E. Laurel Avenue, Foley, AL 36536, as of December 31, 2004. The report of the limited-scope examination is submitted herewith.

Where the description "Company" appears herein without qualification, it will be understood to indicate Baldwin Mutual Insurance Company.

EXAMINATION AFFIDAVIT

STATE OF ALABAMA
COUNTY OF MOBILE

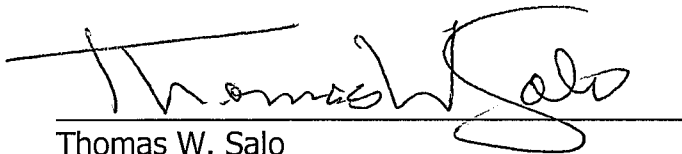
Thomas W. Salo being first duly sworn, upon his oath deposes and says:

That he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;

That a limited-scope examination was made of the affairs and financial condition of Baldwin Mutual Insurance Company for the period of January 1, 2002 through December 31, 2004.


That the following 40 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

And, that the statements, exhibits, and data therein contained are true and correct to the best of his knowledge and belief.



Thomas W. Salo
Examiner-in-charge

Subscribed and sworn to before the undersigned authority this August 25, 2006,


(Signature of Notary Public)

SHARON BAKER Notary Public
Printed name

in and for the State of Alabama

My commission expires 6-20-07

IDENTIFICATION OF THE COMPANY

The company being examined is Baldwin Mutual Insurance Company, a Property and Casualty insurer which is located in Foley, Alabama. The Company's main lines of business are fire and allied lines. The date of the last full scope combined financial and market conduct examination covered the five-year period ended December 31, 2002, and was conducted by examiners from the Alabama Department of Insurance.

The Company became financially impaired as a result of the huge losses resulting from devastation associated with Hurricane Ivan. A Show Cause Order was issued to the Company on April 5, 2005 because the Company's surplus decreased 84% within one quarter as of December 31, 2004, from \$8,600,000 to \$1,200,000.

The need for the limited-scope examination arose because of the aforementioned decrease in surplus and the numerous complaints that were received from the Company's policyholders at the Alabama Department of Insurance about inadequate claims servicing related to Hurricane Ivan.

DISCLOSURE

This report is a limited scope examination, and is not intended to communicate all matters of importance for an understanding of the Company's financial condition.

SCOPE OF THE EXAMINATION

This limited-scope examination reported herein covers the period from January 1, 2002 through December 31, 2004, and has been conducted by examiners representing the State of Alabama Department of Insurance. Events subsequent to December 31, 2004, have been reviewed, and are reported herein, as deemed appropriate.

The limited-scope examination has been conducted in accordance with statutory requirements of the *Alabama Insurance Code* and regulations and bulletins of the Alabama Department of Insurance; in accordance with the applicable guidelines and procedures of the National Association of Insurance Commissioners (NAIC); and in accordance with generally accepted examination standards.

A market conduct examination was performed concurrently with the limited-scope financial examination. The market conduct examination included a review

of the Company's operations/management; complaint handling; policyholder service; and claims. See page 5 for further discussion of the market conduct examination. Certain required elements relating to these areas of examination will be included in this report. However, where no exceptions were noted in particular areas, details of the various tests conducted are not included. If exceptions were identified as part of this examination, the details of the exceptions, the related tests, and recommendations are included in the appropriate sections of this Report of Examination.

Concerns that will be addressed in this limited scope examination are, but not limited to the following:

Sale of the Company's home office

It will be determined if the sale was an arm's length transaction. The fairness of the sale will be examined and the gain or loss will be recomputed. The Company's liability insurance coverage will be examined for its sufficiency.

Review of State Farm 70/30 quota-share reinsurance treaty

This treaty will be examined to determine how it affected the Company's surplus. It will also be reviewed as part of the Company's reinsurance program.

Adequacy of loss reserves including impact of Hurricane Ivan on reserves.

Loss reserves will be examined and tested by the actuary representing the Alabama Department of Insurance to determine their sufficiency.

Adequacy of Company's reinsurance program including catastrophe coverages.

The Company's reinsurance program, including its new catastrophic coverages, will be reviewed to determine their adequacy.

Claims payment practices and complaint handling.

Individual claim files will be reviewed to determine accuracy and timeliness of payment. Record retention and complaint documentation will be examined along with the Company's policies and procedures for the handling of policyholder's complaints.

Risk-Based Capital (RBC) report

The Company's RBC report will be reviewed to determine its accuracy.

Recalculation of President's Salary

The salary of Ralph T. Russell, President of the Company, will be reviewed along with its new method of calculation.

ORGANIZATION AND HISTORY

The Company was incorporated on July 21, 1921, under the laws of the State of Alabama as "Baldwin Mutual Insurance Company, Incorporated."

The objectives or purposes of the incorporation, as set forth in the Certificate of Incorporation, were to issue policies and enter into contracts of insurance and to reinsure or accept reinsurance on any portion thereof for fire, liability, disability, automobile, steam boiler, use and occupancy, title and miscellaneous insurance, which are not prohibited by statute or at common law from being the subject of insurance, excepting life insurance.

The Company was organized as a mutual insurance corporation and continues to operate under the mutual plan with no capital stock. No amendments to the Articles of Incorporation occurred during the current examination period. On February 26, 1998, by a unanimous vote of the policyholders, Section 4.A. of Article VI, of the By-Laws, was changed to include the position of Chairman of the Board.

At December 31, 2004, the Company's Annual Statement reflected *Surplus as regards policyholders* of \$1,229,346.

FINANCIAL GROWTH OF THE COMPANY

The following schedule presents financial data, which reflects the growth of the Company for the years indicated:

(continued next page)

<u>Year</u>	<u>Net Written Premiums</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Capital and Surplus</u>
2001	\$9,036,105	\$13,744,403	\$5,733,956	\$8,010,447
2002	\$9,464,395	\$12,819,708	\$6,250,862	\$6,568,846
2003	\$9,434,532	\$15,428,570	\$6,560,587	\$8,867,983
2004	\$10,347,968	\$ 8,448,381	\$ 8,420,085	\$ 28,296

Data for the years 2001 and 2003 are per the Company's annual statements.
Data for 2002 and 2004 are per examination.

EXAMINATION FINDINGS

MARKET CONDUCT

COMPLAINT HANDLING

The examiner received documentation from ALDOI indicating that they had received approximately 140 complaints on the Company between September 16, 2004 and April 28, 2005. Twenty of these complaints were selected and reviewed for proper documentation.

COMPLAINT HANDLING STANDARD 1 - All complaints are records in the required format on the Company complaint register.

Even though the Company is maintaining a complaint register, sixteen of the twenty aforementioned complaints were not on this register. The Company is not maintaining a complaint register as defined by Complaint Handling Standard 1 of the NAIC's Market Conduct Examiners Handbook, and ALA CODE § 27-27-29(a)(1975), which states that an insurer should maintain complete records of its insurance transactions and affairs.

COMPLAINT HANDLING STANDARD 2 – The Company has adequate complaint handling procedures in place and communicates such procedures to policyholders.

The Company has some procedures in place for the handling of complaints. The procedures are not sufficient and did not appear to be easily understood by the policyholders, as set forth in Complaint Handling Standard 2 of the NAIC's Market Conduct Examiners Handbook and ALA CODE § 27-27-29(a)(1975), which states that an insurer should maintain complete records of its insurance transactions and affairs.

COMPLAINT HANDLING STANDARD 3 – The Company takes adequate steps to finalize and dispose of the complaint in accordance with applicable statutes, rules, regulations, and contract language.

A review of the files relating to the twenty complaints denoted that the Company was not maintaining all of the required information that indicated that complaints were properly dealt with as prescribed in Complaint Handling Standard 3 of the NAIC's Market Conduct Examiner's Handbook and ALA. CODE § 27-27-29(a)(1975), relating to the maintenance of complete and accurate records.

The documentation that was lacking was evidence of the finalization or disposition of the complaint and no information from the Company was entered into the particular files on complaints that were discussed with ALDOI personnel.

COMPLAINT HANDLING STANDARD 4 – The time frame within which the Company responds to complaints is in accordance with applicable statutes, rules and regulations.

As mentioned previously, the Company did not maintain sufficient responses to complaints which could be utilized to ascertain the response time as required by Standard 4 of the NAIC's Market Conduct Examiners Handbook

CLAIMS

Claims Payment Practices

CLAIMS STANDARD 2 – Timely investigations are conducted

CLAIMS STANDARD 3 – Claims are resolved in a timely manner

The examiner selected a sample of 47 claims files which were categorized as "Outstanding Claims at December 31, 2004. From these 47 policy/claim files it was determined that:

- eight of these files did not contain any claim information whatsoever

- fourteen of these files did not contain report dates and expediency of claims resolution was indeterminable
- eleven claims were paid 45 days in excess of the report date that was listed, with no written explanation in the file for the inordinate amount of time involved in resolving the claim
- eleven claims were justifiably denied/closed without payment, but a denial notice was not evidenced within the files.

These practices or lack thereof, are not in accordance with ALA CODE § 27-27-29(a)(1975), which states that an insurer should maintain complete records of its insurance transactions and affairs.

CLAIMS STANDARD 10 – Claim files are reserved in accordance with the Company's established procedures.

The examiner reviewed the Company's claims that evolved into litigation. In this review, it was noted that there were seventeen files pending litigation and six more that were near that status. During the examination of these files it was noted that none of them contained any case reserves for loss or LAE. Company personnel indicated that reserves would be established for any claims that were not resolved within 30 days. The fact that these files did not have established reserves is a direct violation of Company policy and Claims Standard 10 of the NAIC's Market Conduct Examiners Handbook.

CLAIMS STANDARD 11 – Denied and closed without payment claims are handled in accordance with policy provisions and state law.

The claims department of the Company was unable to provide a listing of denied and closed without payment claims. As a causal result of this information not being available, the examiner was unable to determine if any denial notices were sent to insureds, and whether the denied or closed without payment claims were based on state law and/or policy provisions. ALA. ADMIN. CODE 482-1-125-.04(2003) states that an "insurer shall maintain claim files that are accessible and retrievable for examination..." and includes "information...for all claims closed without payment."

SALE OF COMPANY'S HOME OFFICE

The Company suffered huge losses as a result of the many claims associated with Hurricane Ivan and these claims far exceeded the Company's reinsurance program and resulted in the Company becoming financially impaired. In order to enhance its surplus position, the Company was forced to sell its home office in Foley, Alabama. The home office was sold on April 8, 2005 for \$3,000,000 to Baldwin Mutual Properties, LLC., which is a corporation not associated with the

Company. The financial effect of the home office sale was that it netted \$370,722.

In conjunction with, and immediately after the sale of the home office, the Company (tenant) entered into a lease-back agreement with its new landlord. The terms of the lease are that the tenant shall pay the landlord \$30,000 per month at the rate of \$360,000 per annum, and that this lease may be extended for up to two additional five-year terms by giving landlord at least 90 days written notice before the end of the original term. In no event shall the initial term of the lease be extended for a period of more than ten years.

The Company still maintains coverage to protect the property that it owns within the building. Further, the Company's liability coverage and limits were reviewed and were deemed to adequately protect the Company's interests at the examination date.

REVIEW OF STATE FARM 70/30 REINSURANCE TREATY

In order to provide additional reinsurance coverage and most importantly, to provide an initial infusion to the Company's surplus, the Company entered into a 70/30 quota-share reinsurance contract with State Farm Insurance, Bloomington, Illinois.

This particular contract is a surplus relief treaty, whereby Baldwin Mutual Insurance Company (BMIC) was able to "cash in" some of the equity in their unearned premium reserves. By entering into this treaty with State Farm, BMIC was able to recognize a \$1,243,000 gain in surplus for the year ended December 31, 2004.

This treaty will be discussed further under the Reinsurance portion of this report, but because of the large impact it had on the Company's surplus position at December 31, 2004, it is included here also.

ADEQUACY OF LOSS RESERVES INCLUDING IMPACT OF HURRICANE IVAN ON RESERVES

The development of Hurricane Ivan claims in 2005 far exceeded the Company and their consulting actuary's predictions. In our opinion, the consulting actuary's reserve analyses and conclusions were reasonable, given the information available at that time. However, given the subsequent development, it is our opinion that the 2004 Annual Statement reserves were materially understated. Therefore, we recommend the following adjustments, for examination purposes:

(continued next page)

	2004 Annual Statement	Recommended Adjustment	Examination Reserves
Net Loss Reserves	\$3,129,668	\$1,044,332	\$4,174,000
Net LAE Reserves	\$ 179,282	\$ 156,718	\$ 336,000
Total	\$3,308,950	\$1,201,050	\$4,510,000

The losses related to Hurricane Ivan far exceeded the Company's 2004 catastrophe reinsurance protection. In 2004, the catastrophe reinsurance covered 95% of \$9,000,000 in excess of a \$1,000,000 retention. Hurricane Ivan losses and allocated loss adjustment expenses (ALAE) are projected to ultimately reach approximately \$21,500,000. It is our understanding that Hurricane Ivan was considered a one-in-one-hundred-year event for the state of Alabama. BMIC's catastrophe reinsurance for 2005 provides coverage related to a \$20,000,000 event, similar to BMIC's Hurricane Ivan incurred losses and ALAE. The quota-share coverage also helps to cover losses above that level. Given these observations, it appears that the Company's current catastrophe reinsurance is adequate. However, the examiners recommend that the Company obtain a thorough review of the catastrophe exposure at least every three to five years. The large reinsurers and reinsurance brokers have sophisticated models that can evaluate the Company's probable maximum losses based on underlying exposures.

LAE payments were not correctly allocated to defense and cost containment (DCC) and adjusting and other (A&O) categories within the Annual Statement. The Annual Statement did not reflect any payments or reserves for unallocated loss adjustment expenses (ULAE). None of the bulk and IBNR reserves attributable to ALAE were allocated to LAE within the Annual Statement. Those reserves were included with bulk and IBNR loss reserves. The examiners recommend that the Company correctly account for total LAE payments and reserves in future annual statements in accordance with SSAP 55. It is further recommended that those LAE payments and reserves be correctly allocated to the DCC and A&O portions in accordance with SSAP 70. **(also see NOTE 1 of NOTES TO FINANCIAL STATEMENTS page 19).**

REINSURANCE

The Company's retention relating to its specific excess-of-loss reinsurance coverage has been fairly consistent in recent years through year-end 2004. From 1998 through 2001, the Company retained \$50,000 and \$25,000 per claim

for property and liability exposure, respectively. In 2002, the retention increased to \$60,000 for property and \$30,000 for liability. The Company also increased their per-occurrence catastrophe retention from \$500,000 to \$1,000,000 in 2002.

The Company's 2005 reinsurance structure is described in the following subsections of this report.

State Farm Quota-Share

There is a quota-share reinsurance contract between Baldwin Mutual and State Farm. It is a surplus relief treaty, whereby Baldwin Mutual was able to convert some of the equity in their unearned premium reserves to surplus at year-end 2004.

Effective 11:59 pm December 31, 2004, State Farm assumed 70% of net-of-specific-excess unearned premium reserves as of that date and the associated losses and ALAE. The contract applies to the first \$40,000,000 of losses and ALAE per occurrence, so the reinsurer's limit of liability is 70% of \$40,000,000 or \$28,000,000. Surplus relief is provided by the ceding commission, which is fixed at 43.5%. The 2004 Annual Statement reflects a cession of 70% of unearned premium reserves, or \$2,856,000 according to Schedule F. BMIC actually paid that amount less the 43.5% commission to State Farm. In other words, BMIC pays \$1,613,000, and the remaining \$1,243,000 was immediately recognized as a gain in surplus.

Essentially, the \$1,243,000 amount represents the pre-paid expenses, such as commissions, and the anticipated profit that BMIC would have realized during the 2005 year on that 70% portion of their unearned premiums.

The State Farm contract applies after the specific excess reinsurance, but inures to the benefit of BMIC's catastrophe reinsurance, which is discussed later. Also, the contract covers only property, not liability claims.

The contract meets all the criteria for risk transfer and reinsurance accounting treatment, on a stand-alone basis. According to Company personnel, there are not any side agreements that impact the application of this reinsurance coverage.

General Re, Excess of Loss

Contract 8993 was originally effective January 1, 2002. This contract, along with subsequent endorsements applies to the 2005 accident year. Exhibit A of the contract addresses property reinsurance and Exhibit B addresses liability reinsurance.

According to Endorsement 2, the Company retains the first \$70,000 of property losses. In the first excess layer, \$30,000 per claim is ceded. The second layer provides \$200,000 excess of \$100,000 per claim coverage. According to the contract, the Company's retention applies to losses only, with the reinsurer assuming excess losses and pro-rata ALAE. The reinsurer's limit applies to combined losses and ALAE ceded to the reinsurer. Endorsement 3 was effective April 1, 2005. This endorsement only terminated Exhibit A of the agreement, which was the property excess of loss coverage.

The first layer reinsurance premium is subject to retrospective experience adjustment. The final premiums are calculated as the product of 100/82 (or 1.22) and reinsured losses and ALAE. The experience period includes three years of losses and ALAE. The final premium adjustment is subject to a minimum of 40% and a maximum of 150% of the earned net provisional reinsurance premiums. Year-end 2004 represented the end of the 2002 through 2004 experience period. It appears that the Company did not book any reinsurance premiums receivable or payable in the 2004 Annual Statement.

The first layer of property reinsurance provides very minimal risk transfer. The reinsurer's underwriting loss could exceed 10% under the terms of the reinsurance coverage. Therefore, based on the generalized 10/10 rule, it appears that the Company would be allowed to account for the property coverage as reinsurance. However, the Company should accrue the expected premium adjustments and book those expected adjustments in the financial statements.

The liability reinsurance covers \$250,000 excess of \$50,000 per occurrence losses plus pro rata ALAE. Unlike the property coverage, the reinsurer's limit does not specifically apply to combined losses and ALAE. Apparently, the reinsurer could be responsible for up to \$250,000 of losses plus their proportionate share of ALAE for each claim. The reinsurance limit also allows for excess coverage on underlying policies with limits of \$500,000, upon acceptance by the reinsurer. Endorsement 4, effective May 1, 2005 added a second layer of liability reinsurance covering \$200,000 excess of \$300,000. The liability reinsurance premium rate is set at a fixed percentage of subject earned premium.

General Re, Catastrophe, Contract 9190

There are four layers of catastrophe reinsurance covering 95% of \$5.5 million in excess of the first \$500,000 per occurrence of losses and ALAE. The catastrophe reinsurance applies after application of the State Farm 70% quota-share reinsurance coverage. Therefore, the catastrophe coverage applies to underlying catastrophe losses up to \$20,000,000 (\$6M / 30%).

The contract also provides for one automatic reinstatement of the reinsurance limits, covering two loss events under the one-year contract. The reinsurance

premium for reinstatement is equal to the product of the underlying reinsurance premium rate and the amount of catastrophe limit that is reinstated.

BMIC's Catastrophe Retention

In relationship to direct underlying catastrophe losses, BMIC retains 30% of the first \$1,666,667 (maximum \$500,000), 1.5% of the next \$18,333,333 (maximum \$275,000), and 30% of the next \$20,000,000 (maximum \$6,000,000). There is not any reinsurance coverage for losses above \$40,000,000 per occurrence.

Hurricane Ivan was considered a one-in-one-hundred-year event, with direct losses and ALAE approaching \$22,000,000 for BMIC. In 2004, BMIC recovered their reinsurance limit, 95% of \$9,000,000, or \$8,550,000 from their catastrophe reinsurers for Hurricane Ivan. Under the 2005 reinsurance program, another \$22,000,000 event would result in \$20,625,000 of ceded losses and ALAE. In other words, the Company's retention for a \$22,000,000 million event in 2005 would be \$1,375,000, compared with \$13,450,000 for a 2004 event.

It is common to structure catastrophe reinsurance to provide coverage for a one-in-one-hundred-year event such as Hurricane Ivan. BMIC's catastrophe reinsurance for 2005 provides coverage related to a \$20,000,000 event, similar to BMIC's Hurricane Ivan incurred losses. The quota-share coverage also helps to cover losses above that level. Given these observations, it appears that the Company's current catastrophe reinsurance is adequate. When establishing the 2005 reinsurance structure, it is likely that the reinsurer conducted a more sophisticated analysis of the Company's probable maximum loss.

ACCOUNTS AND RECORDS

ACCOUNTING SYSTEM

During the examination, it was noted that the Company's principal accounting records were maintained primarily on electronic data processing equipment. However, there were certain detail and subsidiary records that were kept in a manual format.

For the years 2003 and 2004, the Company was audited by the certified public accounting (CPA) firm of Leaser & Elder, P.C., (fka Taylor, Leaser & Elder, P.C.), of Foley, Alabama. It was noted that this accounting firm also conducted all of the Company's audits for 1998 through 2002, which was the five-year period covered by the previous full-scope examination. Moreover, the previous examination report revealed that this accounting firm has performed the Company's annual audits for the past twenty years.

With this being a limited-scope examination, all of the CPA workpapers were not

obtained for review. However, the files which related to this examination were tested and utilized in this examination to the extent deemed appropriate.

The Company has utilized the accounting firm of Leaser & Elder, P.C. (or its predecessors), for the past twenty-two years. The NAIC's Annual Statement Instructions and Section 7, of ALDOI *Regulation No. 100*, stipulate that:

"No partner or other person responsible for rendering a report may act in that capacity for more than seven (7) consecutive years. Following any period of service such person shall be disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of two (2) years."

In accordance with said regulation, the Company requested and received relief from the rotation requirement from the ALDOI for the 1997 audit. Further, it was noted that Kevin Leaser was not the CPA who performed the Company's audit for years 1999 and 2000 as these audits were performed by another CPA within the same firm.

The NAIC's Annual Statement Instructions also require that the annual audit shall be conducted by an independent CPA in good standing with the American Institute of Certified Public Accountants (AICPA). The AICPA specifies certain standards for independence, including, among others, that management accepts and understands all work performed and all accounting procedures accomplished by the CPA. The CPAs supervised the accounting operations, prepared monthly financial statements, and were primarily responsible for the preparation of the Company's Quarterly and Annual Statements. Also, this firm maintained the Company's general ledger and provided monthly financial statements to ALDOI. The Company had no internal audit staff; however, the annual financial audit was performed by the CPA firm on its own work.

The independence required of a CPA has not been demonstrated for the purposes of this limited-scope examination.

It was also noted that Article VII, of the Company's By-Laws states that:

"1. The Board of Directors shall cause to be made annually an audit of the company records at the close of the business day on December 31 by a certified public accountant(s).

A. The same individual or firm shall not be employed for any two successive years."

By retaining the same CPA firm for twenty-two years, the Company was in violation of its own By-Laws.

The reserve calculations for the examination period were certified by the Company's actuarial consultant, Mr. Matthew P. Merlino, FCAS, MAAA, with Merlino & Associates, Inc., Norcross, Georgia.

ACCOUNTING RECORDS

The following was excerpted from the previous full-scope examination report as of December 31, 2002, and it also pertains to this examination.

"During the examination period, it was revealed that the Company did not maintain complete electronic data backups as of year-end. Several of the samples utilized during the examination could have been selected electronically with the examiners' audit software had the information been maintained in electronically compatible format. Consequently, numerous samples had to be selected manually thereby delaying the completion of the examination.

Section 3, of ALDOI *Regulation No. 118*, requires that:

"Every insurer... shall maintain its books, records, documents and other business records in order that the insurer's financial condition may be readily ascertained by the Department of Insurance, taking into consideration other record retention requirements. All records must be maintained for not less than five (5) years."

On several occasions, the hard-copy policy/application files were not found in the Company's repository as they were "in process" and in other areas of the building such as locations for claims review, renewals, cancellations, or accounts payable. At times, it took numerous days for the required file to be obtained. This too, proved to be time-consuming and caused delays in the examination process.

During the review of the claim files which were selected from the Company's database, it was noted that three of these files did not have check vouchers for the claim payments. The fact that the Company could not provide the supporting vouchers for these transactions is a violation of ALA. CODE §27-27-30 (1975) which states that "No insurer shall make any disbursement of \$25.00 or more unless evidenced by a voucher or other document correctly describing the consideration for the payment and support by a check or receipt endorsed or signed by, or on behalf of, the person receiving the money."

Further, report dates were not included in the files contained on this database.

Detailed discussions and additional commentary on the above matters may be found in the **COMMENTS AND RECOMMENDATIONS** section of this limited-scope examination report, under the various captions to which they relate.

FINANCIAL STATEMENTS

EXAMINER'S NOTE: SINCE THIS WAS A LIMITED-SCOPE EXAMINATION, CERTAIN AREAS OF THE COMPANY'S FINANCIAL CONDITION WERE **NOT** REVIEWED. EMPHASIS WAS CENTERED ON LOSSES AND LOSS ADJUSTMENT EXPENSE, REAL ESTATE, PAID AND UNPAID CLAIMS, AND REINSURANCE. EXCEPTIONS WILL BE DULY NOTED WITHIN THE FOLLOWING FINANCIAL STATEMENTS. OTHERWISE, AMOUNTS REPORTED IN THE COMPANY'S DECEMBER 31, 2004 ANNUAL STATEMENT WILL BE UTILIZED.

Financial statements included in this report, which reflect the operations of the Company for the years under this limited-scope examination and its financial condition at December 31, 2004, consist of the following:

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**THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL
STATEMENTS ARE AN INTEGRAL PART THEROF.**

STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS

For the year ended December 31, 2004

ASSETS

	<u>Ledger Assets</u>	<u>Non-Admitted Assets</u>	<u>Admitted Assets</u>
Bonds	\$ -		\$ -
Preferred stock	\$ -		\$ -
Common stock	\$ 1,320,754		\$ 1,320,754
Mortgage loans -first liens	\$ 190,562		\$ 190,562
Properties occupied by the Company	\$ 2,908,328		\$ 2,908,328
Properties held for the production of income	\$ 213,043		\$ 213,043
Cash	1,980,337		\$ 1,980,337
Investment income due and accrued	4,462		\$ 4,462
Uncollected premiums & agent balances	835,691		\$ 835,691
Current income tax recoverable	647,780		\$ 647,780
Net deferred tax asset	111,759		\$ 111,759
Guaranty funds receivable on deposit	65,474		\$ 65,474
Furniture and equipment	123,387	\$ 123,387	\$ -
Aggregate write-in for other than invested assets	781,083	\$ 610,892	\$ 170,191
Total Assets	<u>\$ 9,182,660</u>		<u>\$ 8,448,381</u>

LIABILITIES SURPLUS AND OTHER FUNDS

Liabilities

Losses (NOTE 1)	\$ 4,174,000
Loss adjustment expense (NOTE1)	\$ 336,000
Commissions payable	\$ 458,730
Other expenses	\$ 8,094
Taxes, licenses and fees	\$ 7,688
Unearned premiums	\$ 1,421,623
Advance premium	\$ 58,439
Ceded reinsurance premium payable	\$ 1,830,409
Amounts withheld for account of others	<u>\$ 125,102</u>
Total Liabilities	\$ 8,420,085

Surplus and Other Funds

Common capital stock	
Gross paid in and contributed surplus	
Unassigned funds (NOTE)	<u>\$ 28,296</u>
Total capital and surplus	<u>\$ 28,296</u>
Total Liabilities, Surplus and Other Funds	<u>\$ 8,448,381</u>

COMPARATIVE SUMMARY OF OPERATIONS

For The Years Ended December 31,

	<u>2004</u>	<u>2003</u>	<u>2002</u>
<u>Income:</u>			
Premium considerations	\$ 10,347,968	\$ 9,434,532	\$ 8,783,677
Net investment income	1,284,382	243,706	260,939
Write-in for miscellaneous income	<u>1,341,518</u>	<u>11,548</u>	<u>43,716</u>
Finance and service charges			
Total income	\$ 12,973,868	\$ 9,689,786	\$ 9,088,332
<u>Deductions:</u>			
Losses incurred	\$ 15,249,449	\$ 4,202,123	\$ 3,797,643
Loss expenses incurred	\$ 1,752,721	\$ 205,696	\$ 155,370
Other underwriting expenses	3,621,937	4,588,944	3,990,430
Aggregate write -in for underwriting deductions	5,096	48,144	9,744
Total deductions	\$ 20,629,203	\$ 9,044,907	\$ 7,953,187
Federal income taxes incurred	<u>(647,780)</u>	<u>248,980</u>	<u>315,004</u>
Net Income (Loss)	\$ (7,007,555)	\$ 395,899	\$ 820,141

RECONCILIATION OF CAPITAL AND SURPLUS

	For the years ended December 31,		
	<u>2004</u>	<u>2003</u>	<u>2002</u>
Capital and surplus, January 1,	\$ 8,867,983	\$ 8,291,911	\$ 8,010,447
Net income	\$ (7,007,555)	\$ 395,929	\$ 820,141
Change in net income			
Change in net unrealized capital gain or (losses)	\$ (648,287)	\$ 287,930	\$ (238,698)
Increase in loss reserves (NOTE 1)	\$ (1,044,332)		
Increase in loss adjustment expenses (NOTE 1)	\$ (156,718)		
Change in non-admitted assets	(94,554)	(107,787)	\$ (299,979)
Change in net deferred income tax	111,759		
Change in capital and surplus during year	\$ (8,839,687)	\$ 576,072	\$ 281,464
Capital and surplus, December 31,	\$ 28,296	\$ 8,867,983	\$ 8,291,911

NOTES TO THE FINANCIAL STATEMENTS

<u>Note 1 – Losses</u>	<u>\$4,174,000</u>
<u>Loss adjustment expense</u>	<u>\$336,000</u>

The captioned amount for Losses is \$1,044,332 more than the amount reported in the Company's December 31, 2004 Annual Statement and the captioned amount for Loss Adjustment Expenses is \$156,718 more than the amount reported in the Company's December 31, 2004 Annual Statement.

In reviewing the Company's reserves, the examination revealed that the Company's development of Hurricane Ivan's claims far surpassed the Company's and their consulting actuary's forecasts. The Company's consulting actuary's reserve analyses and conclusions were reasonable, given the information and data that was available at that time. However, the claims associated with Hurricane Ivan far exceeded expectations, and the December 31, 2004 Annual Statement reserves were materially understated.

Loss and LAE Reserves – Company (BMIC)

The Company's independent CPA auditor calculated the Company's 2004 Annual Statement booked reserves. The examiners reviewed the Company's reserving procedures in detail. The methods for establishing net-of-reinsurance reserves for losses and ALAE are described in the following subsections of this report.

Case Reserves

The amount of reserves classified as "case reserves" in the 2004 Annual Statement was \$2,844,629. Typically, this would represent the amount of case reserves estimated by claims adjusters for all individual open claims as of December 31, 2004. For BMIC, the booked amount is equal to the sum of payments made from January 1, 2005 through February 10, 2005 and case reserves as of February 10, 2005, all on claims incurred December 31, 2004 and prior.

Bulk and IBNR Reserves

The Company booked \$508,716 of bulk and IBNR loss reserves in the 2004 Annual Statement. This amount is equal to the average of two estimates of bulk and IBNR reserves for total losses and ALAE.

One of the bulk and IBNR estimates resulted from an analysis of historical lag ratios of paid losses and ALAE. Specifically, the numerator of each ratio was calculated as all loss and ALAE payments made for a given accident year after the end of the accident year less the case reserves as defined (for the Annual Statement) above. The denominator is equal to the calendar year (corresponding to the given accident year) reported losses and ALAE. An average of the ratios for several accident years is then calculated. The product of this average ratio and accident year 2004 reported losses and ALAE produced the estimated bulk and IBNR reserves for this method. Some of the theoretical flaws in this method are described below:

- The method roughly estimated bulk and IBNR reserves for only accident year 2004. Any expected development on accident years 2003 and prior was excluded from the result.
- The numerator of the ratio excludes payments expected subsequent to year-end 2004. For instance, the ratio for 2003 includes only one year of paid development. For this reason, we suspect that the resulting ratios for 2002 and 2003 are both understated.

Each of these issues contributes to the understatement of resulting bulk and IBNR reserves for this method. Although this method includes some minor theoretical flaws, it has improved significantly as a direct result of the prior examination recommendations.

The second bulk and IBNR reserve estimate resulted from a development triangle analysis. This method is extremely unusual, but again, it is an improvement over the development method used in 2002. The improvements are a result of the recommendations from our prior examination. The data in the development triangle are labeled as incurred data by accident year although the examiners were not able to reconcile the data in the first column (as of 12 months) to the other loss and ALAE workpapers. The Company's accountant explained that the first valuation represents calendar year case-incurred losses and ALAE. The second valuation represents the sum of the first valuation losses and ALAE and the accident year payments made from 12 to 24 months after the beginning of the accident year, less the case reserves as of the prior year end for the applicable accident year. The third and subsequent valuations simply add the calendar year paid amounts applicable to the accident year. This very unusual development roughly estimates the case reserve deficiency as a percentage of calendar year incurred losses and ALAE. Although it is still not entirely clear, it appears that this triangle method is significantly more reliable than the corresponding method applied in 2002.

Again, the average of the resulting bulk and IBNR estimates from the two methods was selected for the 2004 Annual Statement. The total bulk and IBNR reserves for losses and ALAE were booked as bulk and IBNR loss reserves in the Annual Statement (none allocated to either DCC or A&O).

All of the loss and ALAE reserve calculations were conducted with data that are net of reinsurance. The only booked ceded reserve was a ceded case loss reserve of \$44,000.

The loss and ALAE reserve calculations were also net of salvage and subrogation (S&S) recoveries, resulting in reserves that are net of anticipated S&S recoverable.

The Company does not allocate any of the general overhead expense payments to LAE. Further, the Company did not estimate or book any reserves for ULAE. The examiners reviewed this issue with the Company's accountant. He agreed that there is not any reserve contemplated for ULAE.

The accountant also explained that some of the A&O expenses are applicable to independent claims adjusters. Those paid expenses are included with ALAE data in the reserve analyses, and the case reserve portion of those expenses is booked as DCC in the Annual Statement (rather than with A&O). For this reason, some of the A&O expense reserves are theoretically contemplated in the analysis of loss and ALAE reserves.

Loss and LAE Reserves – Actuarial Reserve Opinion

The actuary representing ALDOI reviewed the reserve opinion prepared by Matthew P. Merlino, FCAS, MAAA, FCA. The most material issue in the 2004 opinion related to Hurricane Ivan's impact on the Company. Claims from the hurricane significantly reduced the Company's surplus and increased the Company's reserves as of year-end 2004.

The actuary's stated materiality standard in the reserve opinion was \$122,935, or 10% of statutory surplus. The reserve study was prepared subsequent to the opinion. After issuing the opinion, but prior to preparing the reserve study, the actuary discovered that adverse development in reserves of just \$28,500 could place the Company under "Mandatory Control Level" based on their risk based capital level. In the reserve study, he stated that he would have selected a lower materiality standard based on this information. However, it would not have changed the opinion otherwise. The opinion still acknowledged a significant risk of adverse deviation.

The examiners also reviewed the actuary's reserve study supporting the reserve opinion. The actuary used standard paid and reported development methods to

estimate ultimate losses and ALAE on a net of reinsurance basis. All of the business was combined for this analysis, and presented in the triangles net of both reinsurance and S&S. Final ultimate losses were selected based on the results of the two methods. Estimated reserves were calculated as the difference between selected ultimate losses and ALAE and actual paid data as of December 31, 2004.

The actuary approximated ULAE reserves by applying an industry factor to one-half of case reserves and all of the bulk and IBNR reserves. This is a generally accepted method that assumes that one-half of the ULAE expenses are paid when a claim is opened, and the remaining one-half when it is closed. The examiners compared the actuary's selected ratio of ULAE to loss and ALAE with the industry data and found that the 4.10% selection was reasonable. However, given that some of BMIC's adjuster expenses are already contemplated in the ALAE reserve estimates, the selected industry ratio (which includes just A&O, not ULAE) may be conservative.

In our opinion, the actuary's net loss and LAE reserving methods and selections were reasonable. The actuary compared resulting loss and LAE reserves, net of reinsurance and S&S, to the Company's booked reserves. The actuary's estimate was approximately \$316,000, or 26% of surplus, lower than booked reserves.

The actuary did not separately address Hurricane Ivan in the reserve analyses. He assumed that the net paid and net reported methods would be appropriate for all claims. It is important to note that the net paid and reported data both reflected the maximum catastrophe reinsurance recovery of \$8,550,000 at year-end 2004. None of the historical data reflected a similar catastrophe or large reinsurance recoveries. The development factors, derived from historical data, were applied to accident year 2004 losses and ALAE, which were net of a very large reinsurance recovery relative to all historical years. Since the catastrophe reinsurance limit was exhausted prior to year-end, the Company will retain all further development on Hurricane Ivan claims. For this reason, the resulting estimate of net ultimate losses and ALAE, derived from net data, may be understated. However, the development on hurricane losses would differ from other years in other respects, as well.

The actuary also reviewed payments and case reserves applicable to just Ivan claims as of four points in time: 11/30/04, 12/31/04, 1/31/05, and 2/14/05. The reported loss and ALAE development in the last increment (prior to issuing the reserve opinion) was miniscule. It appeared at that time that development had settled down. In our first review, the examiners agreed, and thought that booked reserves appeared conservative. (It is important to note that the Ivan claims valued as of 2/14/05 are similar to what is reported in the 2004 Annual Statement.

In summary, it is the examiners opinion that the actuary's assumptions, methods, and resulting reserves were reasonable given the information available to the actuary at the time that the reserve study was prepared.

Loss and LAE Reserves – Examination

The examiners were able to review actual development through September 30, 2005 in our determination of appropriate reserves for year-end 2004. Actual development on Hurricane Ivan claims far exceeded the actuary's estimates. The examination reserves are calculated in the attached exhibit.

The Company's ability to produce detailed claims data and information is very limited. For instance, the number of claims reported, paid, or opened each month was not available. Therefore, the actuary for ALDOI relied largely upon data and information that was summarized manually. The financial examiner reviewed monthly claims payment reports and provided the following summary of losses and ALAE paid through the first nine months of 2005:

	NON-IVAN CLAIMS		IVAN CLAIMS	
MONTH	NUMBER OF CLAIM PAYMENTS	TOTAL PAID	NUMBER OF CLAIM PAYMENTS	TOTAL PAID
January	97	\$ 167,899	1,098	\$ 1,561,999
February	72	\$ 328,307	505	\$ 714,297
March	47	\$ 86,096	603	\$ 596,510
April	7	\$ 18,125	123	\$ 90,436
May	16	\$ 113,755	269	\$ 238,844
June	11	\$ 28,360	200	\$ 62,442
July	7	\$ 4,309	72	\$ 46,188
August	5	\$ 997	42	\$ 56,019
September	4	\$ 533	19	\$ 9,137
Total	169	\$ 748,381	1,833	\$ 3,375,872

The examiners judgmentally allocated the non-Ivan paid data by accident year. Specifically, the examiners assumed that \$16,000 was applicable to 2003 and prior accident years, since that was the amount of case reserves in the 2004 Annual Statement for those years. This produces zero development on reported losses and ALAE for those accident years. The remaining payments were all allocated to accident year 2004.

Company personnel also provided case reserves as of September 30, 2005 on claims incurred prior to 2005. Of the total \$53,000, \$17,000 was applicable to Hurricane Ivan claims. The examiners assumed that the remaining case reserves apply to accident year 2004 claims. Based on discussions with claims personnel,

() the examiner found that there were approximately 17 Hurricane Ivan claims in litigation at the end of September 2005. It is our understanding that the Company has not set case loss or ALAE reserves on any of those claims.

The exhibit shows the calculation of cumulative paid and reported losses and ALAE as of September 30, 2005. The 2005 paid data and case reserve data were gross of reinsurance. The Company was not able to provide ceded data. Since catastrophe reinsurance was previously exhausted for Hurricane Ivan, the examiners suspect that the remaining reinsurance recoveries will be minimal. Therefore, the 2005 reinsurance activity would not be material to the results of this analysis.

Our options for estimating reserves were somewhat limited by the limited available data. The previous table shows that there continues to be activity on Hurricane Ivan claims. The examiners chose to use a standard reported development method. The development factors from the Company's consulting actuary's report were reasonable, in our opinion. Therefore, those development factors were utilized in our analysis. Some of the advantages, disadvantages, and considerations underlying this method are detailed below:

- The development patterns were derived from historical data, which did not include material hurricane experience. However, given the short tail of the historical development and expected short tail of the hurricane claims, it appeared reasonable to apply the average historical development patterns to accident year 2004.
- The historical data from which the patterns were derived were net of reinsurance. In most historical years, only excess-of-loss reinsurance was ceded. This resulted in a historical ratio of net losses to direct losses of roughly 95%. Accident year 2004 cessions were mostly applicable to catastrophe reinsurance. The ratio of net-to-direct for this year was closer to approximately 60%. Furthermore, the catastrophe reinsurance limit was exhausted prior to year-end 2004. Therefore, all further development on Hurricane Ivan claims is fully retained by the Company. The average historical development patterns were applied to losses and ALAE that were net of a very large reinsurance recovery. However further development will not yield further reinsurance recoveries. Since the development factor for accident year 2004 is applied to data that reflect the large catastrophe reinsurance recovery, the net development method may understate estimated ultimate losses and ALAE.
- In discussions with claims personnel, it was also noted that current case reserves on Hurricane Ivan claims appear to be understated. Specifically, there are not any case reserves on approximately fifteen Hurricane Ivan

claims in litigation as of the end of September 2005. This is another reason that the reported development method may tend to understate estimated ultimate losses.

- The reported development factors must be interpolated from a year-end basis to a September 30, 2005 level. For short-tailed lines of business, development factor interpolation does not always produce a reasonable result for the most recent accident year. Most of the late development is normally applicable to claims reported in the first two to three months following the end of the year. Using a standard interpolation procedure applied to September 30 data would normally overstate projected future development. In this instance, given the issues noted above, we chose to use a standard interpolation. To interpolate development factors, we applied a straight-line interpolation to the inverse of the cumulative development patterns. It is important to note that the year-end development patterns for Baldwin Mutual actually represent a mid-February valuation date, and the interpolation also reflects that fact.

Considering the issues listed above, the examiners judgmentally assumed that the aggressive features roughly offset the conservative aspects of the projection. However, these issues increase the uncertainty of the results.

Although the development method provides for additional development on the 2003 and prior accident years, our selected ultimate for those years was equal to the reported losses and ALAE. The resulting projected ultimates provide for approximately \$221,000 of additional development on reported loss and ALAE beyond September 30, 2005. This appears reasonable in relationship to the table of monthly paid data and in consideration of the Company's zero-case-reserve open claims, in our opinion.

The resulting loss and ALAE reserves were used in the estimation of ULAE reserves. The selected ratio of ULAE to losses and ALAE is equal to the ratio selected in the consulting actuary's study, and was based on industry data. The actuary for ALDOI reviewed the industry data and found the ratio to be reasonable. The actuary also noted that industry data actually represents the ratio of A&O to losses and DCC. For a property company such as Baldwin Mutual, the actuary expects this industry ratio to be higher than the ratio of ULAE to losses and ALAE. For this reason, the resulting ULAE reserves may be conservative.

The examination reserve analyses do not separate losses from ALAE. In order to allocate total reserves to the loss and LAE portions, the examiners reviewed the Company's historical relationship of paid LAE to paid losses. The Annual

Statement paid LAE that were reviewed included only ALAE, not ULAE. Therefore, the examiners judgmentally included a provision for ULAE in the selection of the total LAE ratio. The examiners recommend that 7.5% of total examination loss and LAE reserves be allocated to LAE. Resulting examination specific adjustments as of December 31, 2004 are summarized in the Summary and Recommendations which follow.

Summary and Recommendations

The development of Hurricane Ivan claims in 2005 far exceeded the Company and their consulting actuary's predictions. In our opinion, the consulting actuary's reserve analyses and conclusions were reasonable, given the information available at that time. However, given the subsequent development, it is the opinion of the examiners that the 2004 Annual Statement reserves were materially understated. Therefore, the examiners recommend the following adjustments, for examination purposes:

	2004 Annual Statement	Recommended Adjustment	Examination Reserves
Net Loss Reserves	\$3,129,668	\$1,044,332	\$4,174,000
Net LAE Reserves	\$ 179,282	\$ 156,718	\$ 336,000
Total	\$3,308,950	\$1,201,050	\$4,510,000

Losses related to Hurricane Ivan far exceeded the Company's 2004 catastrophe reinsurance protection. In 2004, the catastrophe reinsurance covered 95% of \$9,000,000 in excess of a \$1,000,000 retention. Hurricane Ivan losses and allocated loss adjustment expenses (ALAE) are projected to ultimately reach approximately \$21,500,000. It is the understanding of the examiners that Hurricane Ivan was considered a one-in-one-hundred-year event for the State of Alabama. BMIC's catastrophe reinsurance for 2005 provides coverage related to a \$20,000,000 event, similar to BMIC's Hurricane Ivan incurred losses and ALAE. The quota-share coverage also helps to cover losses above that level. Given these observations, it appears that the Company's current catastrophe reinsurance is adequate. However, the examiners recommend that the Company obtain a thorough review of the catastrophe exposure at least every three to five years. The large reinsurers and reinsurance brokers have sophisticated models that can evaluate the Company's probable maximum losses based on underlying exposures.

LAE payments were not correctly allocated to defense and cost containment (DCC) and adjusting and other (A&O) categories within the Annual Statement. The Annual Statement did not reflect any payments or reserves for unallocated loss adjustment expenses (ULAE). None of the bulk and IBNR reserves

attributable to ALAE were allocated to LAE within the Annual Statement. Those reserves were included with bulk and IBNR loss reserves.

The final resulting loss and LAE reserves of \$4,510,000 are \$1,201,000 greater than the net reserves booked in the 2004 Annual Statement. This is clearly material in relationship to the booked surplus of \$1,229,346. Therefore, the examiners recommend an adjustment, for examination purposes. In hindsight, it appears that the major factors contributing to this deficiency are:

- Case Reserve Adequacy. The basis for 2004 Annual Statement case reserves was the detail listing of open claims as of February 10, 2005. In that listing, there appears to be a disproportionate number of claims with case reserves of exactly \$1,000. Most of those claims were wind claims incurred on September 16, 2004, which are Hurricane Ivan claims. Given the large volume of claims, it appears that the claims personnel did not have the time to evaluate each individual claim and set case reserves based on the merits of the claim. Rather, a selected average case reserve of \$1,000 was set on the majority of Hurricane Ivan claims as of that date.

The Company's claims manager confirmed this when the actuaries discussed the issue with him. He stated that the \$1,000 amount was set up until they had a chance to review the merits of individual claims. In hindsight, he would guess that the average claim size for Hurricane Ivan claims was approximately \$2,500 to \$3,000.

- Re-opened Claims. Based on discussions with Company personnel and their consulting actuary, it appears that the volume of claims being re-opened for additional payment far exceeded initial expectations. The claims manager indicated that claim reopening has been the major problem with settling all Hurricane Ivan claims.
- The claims manager also discussed the impact of contractors and FEMA personnel driving up the average cost of claims. In many instances, the claims adjusters arrive after the claimant has been given high expectations of the amount of covered damage. This has driven much controversy over re-opened and litigated claims.

Data Reconciliations and Audit

There are a few issues regarding the preparation of Schedule P:

- Independent adjuster expense payments were booked as DCC rather than correctly included in the A&O category.

- General expenses applicable to claims management functions and internal claims adjuster expense payments were not included in either DCC or A&O.
- As previously discussed, case reserves booked in the 2004 Annual Statement actually represent reported development through February 10, 2005.
- All bulk and IBNR reserves were booked as loss reserves, rather than allocated to the loss, DCC, and A&O components.
- The Company did not book any ULAE reserves (either as DCC or A&O).

Note 2 – Unassigned funds

\$28,296

The amount of the captioned unassigned funds is \$1,201,050 less than the \$1,229,346 reported in the Company's December 31, 2004 Annual Statement. The following presents a reconciliation of unassigned funds per the Company's filed December 31, 2004 Annual Statement to that developed by this examination.

Unassigned funds balance per Company

\$1,229,346

Examination increase/(decrease) to assets:

CHANGES IN ASSETS

-0-

Examination (increase)/decrease to liabilities:

- Losses (NOTE 1) (\$1,044,332)
- Loss Adjustment Expense (NOTE 1) (\$156,718)

TOTAL (INCREASE) TO LIABILITIES

(\$1,201,050)

Examination increase/(decrease) to
Unassigned Funds

(\$1,201,050)

Unassigned funds balance per examination

\$28,296

CONTINGENT LIABILITIES AND PENDING LITIGATION

Examination of these items included the following: a review of the Company's statutory financial statement disclosures; performance of a search for unrecorded items; and obtaining letters of representation from management and Company's legal counsel.

The Company did not report any contingent liabilities or pending litigation that were deemed to have potential for material adverse action on its surplus. The Company's President and Secretary executed a letter of representation attesting to the non-existence of contested claims, unreported liabilities, and contingencies, as of December 31, 2004, and for the period from January 1, 2005 to January 6, 2006.

The examination found that the Company had seventeen pending lawsuits. Further, six more claims were near being classified as pending law suits. Review of the files associated with these claim files indicated no case reserves for potential losses and/or loss adjustment expense. The potential amounts associated with these litigation files could amass to a material amount. In fact, one of these law suits was recently heard in court on December 12, 2005, and the jury found for the plaintiff and awarded a material amount totaling \$40,000 compensatory damages and \$20,000 punitive damages.

Details of these are discussed further in " Market Conduct " at page 5.

SUBSEQUENT EVENTS

Sale of Company's home office

The Company suffered significant losses from the many claims associated with Hurricane Ivan. The claims far exceeded the Company's reinsurance program and resulted in the Company becoming financially impaired. In order to enhance its surplus position, the Company was forced to sell its home office in Foley, Alabama. The home office was sold on April 8, 2005 for \$3,000,000 to Baldwin Mutual Properties, LLC., which is a corporation not associated with the Company. The financial effect of the home office sale was that it netted \$370,722.05.

In conjunction with, and immediately after the sale of the home office, the Company (tenant) entered into a lease-back agreement with its new landlord. The terms of the lease are that the tenant shall pay the landlord \$30,000 per month at the rate of \$360,000 per annum, and that this lease may be extended for up to two additional five-year terms by giving landlord at least ninety days

written notice before the end of the original term. In no event shall the initial term of the lease be extended for a period of more than ten years.

The Company still maintains coverage to protect the property that it owns within the building. Further, the Company's liability coverage and limits were reviewed and were deemed to adequately protect the Company's interests at the examination date.

Update of Reserves as of September 30, 2005

As mentioned elsewhere in this report, the Company suffered significant losses from Hurricane Ivan and the claims far exceeded the Company's expectations. These claims exhausted the limits of the Company's reinsurance program and caused the Company to become financially impaired. The Company obtained a new quota-share reinsurance program with State Farm Insurance and also renegotiated its catastrophe coverage treaty with General Reinsurance Corporation. These new reinsurance treaties were in force when Hurricane Katrina hit the Gulf Coast region and significantly limited the Company's losses to this major wind event.

However, a reserving issue was determined to exist at September 30, 2005. The prior and current examinations determined that the Company had not historically booked any reserves for unallocated loss adjustment expenses (ULAE). Company personnel indicated that ULAE was covered under the quota-share reinsurance treaty. The examiners have determined that this is not the case and referred the Company's accountant to the specific paragraph within the reinsurance contract that explicitly states that ULAE is not covered. There exists disagreement between the examiners and the Company over this issue and the Company was not willing to discuss this any further.

Nevertheless, the examiners found that the Company had a reserve deficiency of \$389,000 as of September 30, 2005.

The calculation for this follows:

September 30, 2005 Net Loss and LAE reserves	\$742,000
September 30, 2005 Booked Loss and LAE reserves	<u>\$353,000</u>
Indicated Reserve Deficiency	(\$389,000)

The primary reasons for this difference are as follows:

- As previously stated, the Company has never booked any reserves for ULAE. The examination estimate for ULAE reserves is \$127,000 as of September 30, 2005.

- Company personnel indicated that the booked reserves were based on the Claim Manager's estimates, or case reserves. Examination reserves include bulk and IBNR reserves in addition to the case reserves. The Company has seventeen claims in litigation and six claims near litigation resulting from Hurricane Ivan claims and the Company's case reserves for these are zero. One of these suits was recently heard in court and the jury awarded the plaintiff \$40,000 in compensatory damages and \$20,000 in punitive damages. These additional losses were not contemplated in the booked case reserves. The examination estimated reserves include bulk and IBNR reserves for these Hurricane Ivan claims, as well for all other reported and unreported claims.

There is a deficiency in the Company's September 30, 2005 Quarterly Statement reserves of \$389,000 (\$198,000 Losses and \$191,000 LAE).

Loan from Affiliate

It was noted that the Company borrowed \$300,000, at the Colonial Bank's money-market rate, from its subsidiary, Gulf Coast Title Insurance Company (GCTIC) on October 3, 2005. The Company owns 93.82% of this subsidiary. The loan was repaid, without interest, on October 31, 2005. On November 1, 2005, the Company borrowed \$340,000 from GCTIC under the same terms. This loan was repaid, without interest on November 3, 2005. Nevertheless, loans to controlling stockholders are excluded as admitted assets in accordance with ALA. CODE §27-37-2 (1975). Also, ALA. CODE §27-29-5(a)(1)(1975) requires that all transactions between affiliates be fair and reasonable. It does not appear to be fair and reasonable for a parent company to enter into a transaction with a subsidiary that results in a non-admitted investment, and therefore a surplus decrease to the subsidiary company.

Further, ALA. CODE §27-41-36(a)(1975) states, "(a) After January 1, 1978, an insurer shall not invest in nor lend its funds upon the security of any note or other evidence of indebtedness of any director, officer or controlling stockholder of the insurer, except as to policy loans authorized under ALA. CODE §27-41-25(1975) and except as provided in §27-1-2, §27-27-26(1975) and §27-37-2(1975) of the Alabama Insurance Code."

President's Salary Calculation

During the last full-scope examination it was found that the President of the Company was receiving commissions from the Company as part of his salary. This is a violation of ALA. CODE § 27-27-26(1975) which states that "Any officer, or director...shall not take or receive to his own use any fee, brokerage,

commission, gift or other consideration, for, or on account of, any such transaction made by, or on behalf of, such insurer."

To be in compliance, it was verified that the Company elected to do the following: On or about April 30, 2005, the Company changed the methodology by which Ralph Timothy Russell, President of the Company, received his compensation. The new salary calculation is to be based on Mr. Russell's average salary for the five (5) preceding years (December 31, 2000 through December 31, 2004). The examination findings verified that Mr. Russell no longer receives salary compensation via commissions.

The Company's by-laws from 1947 clearly state that the salaries of officers are to be set by the Board of Directors. Even though the Company developed a new methodology for calculating the President's salary and put this in force, the new salary and its methodology has not been approved by the Board of Directors as prescribed in the Company's by-laws.

Leasehold Improvements to Gulf Coast Title Insurance Company warehouse

During the review of events subsequent to December 31, 2004, it was noted that the Company reported \$169,000 as a leasehold improvement in their June 30, 2005 Quarterly Statement in Schedule A - Part 2.

The Company had many contractors and adjusters working on their Hurricane Ivan claims who needed a place to stay and to store their supplies and materials. A bartering scheme was developed whereby the Company provided free rent and storage to the adjusters and contractors who worked their Hurricane Ivan claims. In turn, and in lieu of paying rent to the Company, the contractors and adjusters utilized their surplus supplies, material and labor to renovate the warehouse (which is owned by the Company's affiliate, Gulf Coast Title Insurance Company (GCTIC) and is leased by the Company. The Company treated these bartered transactions (the repairs) as recoveries and assigned various estimated amounts to seventeen different policies with the total of the repairs equaling \$169,000.

Supposedly, when GCTIC sells the building, the Company will recoup the \$169,000.

The NAIC's Accounting Practices and Procedures Manual, under SSAP No. 19, paragraph number 5, provides specific guidance on leasehold improvements. "Leasehold improvements that increase the value and enhance the usefulness of the leased asset meet the definition of assets as established in SSAP No. 4. Within that definition, such items also meet criteria defining nonadmitted assets.

Accordingly, such assets shall be reported as nonadmitted assets and charged against surplus."

Therefore, the \$169,000 must be nonadmitted from the Company's June 30, 2005 Quarterly Statement.

Risk-Based Capital

Per ALA. CODE § 27-2B-4(1975) which states "(a) "Company action level event" means any of the following events:

(1) The filing of an RBC report by an insurer which indicates either of the following:

a. The insurer's total adjusted capital is greater than or equal to its regulatory action level RBC, but less than its company action level RBC."

The Company, in its "Projected 2005 RBC Report," has triggered a RBC action level of Company Action Level RBC as prescribed in the aforementioned statute. Significant adjustments in this projected report included:

- Sale of the Company's home office \$2,620,472
- Federal income tax recoverable reduced for 2005 collected amounts of \$638,575
- Net written premiums (NWP) adjusted to reflect quota-share reinsurance. NWP reduced to \$2,940,000
- Capital and surplus reported at December 31, 2004 amounts

The following figures were provided by the Company in its "Projected 2005 RBC report which incorporates the sale of the Company's home office:

Total Adjusted Capital per December 31, 2004 statement	\$1,229,346
Authorized Control Level = 100% of Authorized Control Level	\$665,385
Regulatory Action Level = 150% of Authorized Control Level	\$998,078
<u>Company Action Level = 200% of Authorized Control Level</u>	<u>\$1,330,770</u>

However, the calculation of the Company's Risk-Based Capital (RBC) after the adjustments to the Company's September 30, 2005 Annual statement follows:

Total Adjusted Capital (per September 30, 2005 statement)	\$1,502,708
Loss and LAE Reserve Adjustment	(389,000)
Nonadmitted Leasehold Improvements	(167,944)
[\$169,000-1056 {3 mos. Depr.} = \$167,944]	
TOTAL ADJUSTED CAPITAL	\$945,764

Per the Company's 2005 Projected RBC report, the Company's Authorized Control Level = **\$665,285**

Total Adjusted Capital per adjusted September 30, 2005 stmt. = \$945,764
 Company Action Level= 200% of Authorized Control Level = \$1,330,770
Regulatory Control Level = 150% of Authorized Control Level = \$998,078
 Authorized Control Level = 100% of Authorized Control Level = \$665,285
 Mandatory Control Level = 70% of Authororized Control Level = \$465,769

**The Company is at a Regulatory Control Level and the
 RBC = 945,764/665,285 = 142**

At the regulatory control level, an insurance company is required to file an action plan, and the insurance commissioner is required to perform any examinations or analyses to the Company's business or operations that are deemed necessary. The insurance commissioner also issues appropriate corrective orders to address the Company's financial problems.

Repetitive Use of Certified Public Accountant (CPA)

During the review of the minutes from the December 19, 2005 board meeting, it was noted that, once again, the Company's board unanimously approved the retention of Kevin Leaser, CPA, for services that include accounting, tax preparation and the annual audit.

If Mr. Leaser accepts these responsibilities, this will be the 23rd successive year that he or a prior member of his firm has performed these responsibilities. This issue was previously addressed in the last full-scope examination and is also addressed in this report under Comments and Recommendations-Accounts and Records.

Amendment to By-Laws

On or about February 24, 2005, the Company's Board of Directors amended its By-Laws and unanimously adopted the following:

Article VII 1.A is hereby deleted and the following is substituted in its stead: "The individual or firm employed to conduct the annual audit shall

be determined by the Board of Directors.”

COMMENTS AND RECOMMENDATIONS

COMPLAINT HANDLING— page 5

It is recommended that the Company maintain a complaint register in accordance with Complaint Handling Standard 1 of the NAIC’s Market Conduct Examiners Handbook, and ALA. CODE § 27-27-29(a) (1975), which requires that a company maintain all records of its insurance transactions and affairs.

This recommendation was also made in the previous full-scope examination report.

Complaint Procedures Manual –page 5

It is recommended that the Company have written guidelines for complaint procedures to ensure that complaints are satisfactorily distributed, recorded and responded to, and communicate this to policyholders as defined by Complaint Handling Standard 2, of the NAIC’s Market Conduct Examiners Handbook.

This recommendation was also made in the previous full-scope examination report.

Complaint Documentation –page 6

It is recommended that the Company keep complete records as required by ALA. CODE § 27-27-29(a) (1975), for responses to complaints received from consumers.

This recommendation was also made in the previous full-scope examination report.

It is recommended that the Company maintain records that evidence the finalization and disposition of complaints, as required by Complaint Handling Standard 3, of the NAIC’s Market Conduct Examiners Handbook, and the Company’s replies to the ALDOI within the 10-day time frame, in accordance with ALDOI *Regulation No. 118*.

This recommendation was also made in the previous full-scope examination report.

Response Time – page 6

It is recommended that the Company keep adequate documentation and respond to complaints in accordance with ALDOI *Regulation No. 118*, and Complaint Handling Standard 4, of the NAIC's Market Conduct Examiners Handbook.

This recommendation was also made in the previous full-scope examination report.

PAID CLAIMS-page 6

Timeliness of payment- page 6

It is recommended that the Company maintain its claim files so that timeliness of claims resolution can be determined in accordance with ALA CODE § 27-27-29(a)(1975), which states that an insurer should maintain complete records of its insurance transactions and affairs.

Claim files are reserved in accordance with the Company's established procedures-page 7

It is recommended that the Company include a reserve for all claims that are not settled within 30 days in accordance with the Company's policy.

Denied and closed-without-payment claims – page 7

It is recommended that the Company maintain claims records in accordance with ALDOI *Regulation No. 118*, Section 3, which states that an insurer shall maintain its books, records and documents to readily ascertain the Company's financial condition, and ALA. CODE § 27-27-29 (1975), which states that "every domestic insurer shall have, and maintain...complete records of its assets, transactions and affairs..."

It is also recommended that the Company comply with ALA. ADMIN CODE 482-1-125-.04 (2003), which states that an "insurer shall maintain claim files that are "accessible and retrievable for an examination" in order to conduct a proper examination on the basis for all closed without payment claims.

These recommendations were also made in the previous full-scope examination report.

Notices of Claim Denials to Policyholders – page 7

It is recommended that the Company maintain claims records in accordance with ALDOI *Regulation No. 118*, Section 3 which requires an insurer to maintain its records in order to make a determination on the financial condition of the Company.

In order to determine the basis for all denied claims, **it is recommended** that the Company comply with Section (a) of ALA. ADMIN CODE 482-1-125-.04 (2003), which states that "the insurer shall maintain claim files that are accessible and retrievable for examination."

These recommendations were also made in the previous full-scope examination report.

Accounts and Records- page 12

It is recommended that the Company maintain its records in accordance with ALA. CODE § 27-27-29(a)(1975), which states:

"Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted."

It is recommended that the Company maintain accurate records of its business affairs and retain supporting vouchers for the issuance of checks in excess of \$25.00 in accordance with ALA. CODE §27-27-30(1975).

It is further recommended that the Company maintain the report date in its claim files and in its paid claims database.

It is recommended that the Company rotate its engagement partner in accordance with ALDOI *Regulation No. 100*, which requires that the partner or person responsible for rendering the annual audit report not act in that capacity for more than seven consecutive years. This recommendation was also made in the previous full-scope examination report.

It is recommended that the Company comply with its by laws. The examiner noted the Company did not comply with its By-Laws with regard to the CPA

requirement. The Company had to amend its By-Laws subsequent to the examination.

It is recommended that the CPA firm engaged to perform the Company's annual financial audit demonstrate independence and not perform other accounting functions for the Company, including, but not limited to, supervision of the accounting operations, preparation of monthly financial statements, and the compilation of Quarterly and Annual Statements.

The above-mentioned recommendations were also made in the previous full-scope examination report.

The Company disagrees with the examiner's comments related to independence but has chosen not to object to this finding based on its agreement with the Alabama Department of Insurance, that in the future, an engagement partner for the annual audits shall not perform the work referred to above by the examiner.

Loss and LAE reserves-see Note 1 to Financial Statements - page 19

It is recommended that the Company obtain a thorough review of the catastrophe exposure at least every three to five years.

It is recommended that the Company increase its loss reserves by \$1,044,332 to a total of \$4,174,000 and its LAE reserves by \$156,718 to a total of \$336,000 in its December 31, 2004 Annual Statement

It is recommended that the Company correctly account for total LAE payments and reserves in future annual statements in accordance with SSAP 55.

It is further recommended that those LAE payments and reserves be correctly allocated to the DCC and A&O portions in accordance with SSAP 70.

Update of reserves as of September 30, 2005- page 30

It is recommended that the Company adjust its September 30, 2005 Quarterly Statement to reflect a deficiency in reserves of \$389,000 (\$198,000 Losses and \$191,000 LAE).

President's Salary Calculation- page 31

It is recommended that the salary and its calculation methodology of Mr. Ralph Timothy Russell, President of the Company, be approved by the Board of Directors as prescribed in the Company's by-laws at Article VI paragraph 1.

Loan from Affiliate- page 31

It is recommended that the Company not borrow funds from its affiliate in accordance with ALA. CODE §27-37-2 (1975); ALA. CODE §27-29-5(a)(1)(1975); and ALA. CODE §27-41-36(a)(1975).

Leasehold Improvements to Gulf Coast Title Insurance Warehouse – page 32

It is recommended that the \$169,000 reported as Leasehold Improvements in the June 30, 2005 Quarterly Statement be nonadmitted in accordance with SSAP. No. 19, of the NAIC's Accounting Practices and Procedures Manual.

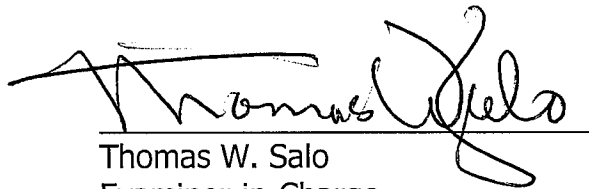
CONCLUSION

Acknowledgement is hereby made of the courteous cooperation extended by persons representing Baldwin Mutual Insurance Company during the course of this examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed in connection with the verification and valuation of assets and the determination of liabilities set forth in this report, to the extent possible utilizing Company records and accounts.

In addition to the undersigned, R. Glenn Taylor, ACAS, MAAA, and Randall D. Ross, ACAS, MAAA, Consulting Actuarial Examiners, all representing the Alabama Department of Insurance, participated in this examination of Baldwin Mutual Insurance Company.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "Thomas W. Salo", is written over a horizontal line.

Thomas W. Salo
Examiner-in-Charge
State of Alabama
Department of Insurance

August 25, 2006